Freddie Mac
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Lisa M. Ledbetter
Vice President and Deputy General Counsel
Legislative & Regulatory Affairs

Tel: (703) 903-3189
Fax: (703) 903-4503
lisa_ledbetter@freddiemac.com

8200 Jones Branch Drive
MS 211
McLean, VA 22102-3110

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Alfred M. Pollard
General Counsel
Attention: Comments – RIN 2590-AA45
Federal Housing Finance Agency
Fourth Floor, 1700 G Street, NW
Washington, DC 20552
By email: RegComments@fhfa.gov

Department of the Treasury
Office of the Comptroller of the Currency
250 E Street SW, Mail Stop 2-3
Washington, DC 20219
RIN 1557-AD43
Docket No. OCC-2011-0008
By email: regs.comments@occ.treas.gov

Jennifer J. Johnson
Secretary
Board of Governors of the Federal
Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1415
RIN 7100-AD74
By email: regs.comments@federalreserve.gov

Gary K. Van Meter
Acting Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102–5090
RIN 3052-AC69
By email: reg-comm@fca.gov

Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
RIN 3064-AD79
By email: Comments@FDIC.gov

Re: Notice of Proposed Rulemaking: Margin and Capital Requirements for Covered Swap Entities

Ladies and Gentleman:

Freddie Mac is pleased to submit these comments in response to the Notice of Proposed Rulemaking regarding Margin and Capital Requirements for Covered Swap Entities, published jointly by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency (FHFA), and the Farm Credit Administration (collectively, the Prudential Regulators) on May 11, 2011 (the Proposal).[1] The Proposal is issued under Sections 731 and 764 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which require the Prudential Regulators to adopt rules to establish capital and initial and variation margin requirements on non-cleared swaps and non-cleared security-based swaps.

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[1] 76 Fed. Reg. 27,564.

Freddie Mac was chartered by Congress in 1970 with a public mission to stabilize the nation's residential mortgage markets and expand opportunities for affordable homeownership and rental housing. Our statutory mission is to provide liquidity, stability and affordability to the U.S. housing market. Freddie Mac uses swaps to hedge large-scale commercial risks on an ongoing basis. Freddie Mac currently operates under the direction of FHFA as our Conservator.

Summary and Recommendations

Freddie Mac supports the efforts of the Prudential Regulators to implement the Dodd-Frank Act and its objective of enhancing stability and transparency in the swaps markets, and strongly supports the efforts of the Prudential Regulators and the Commodity Futures Trading Commission (CFTC) to effectuate the Dodd-Frank Act's mandatory clearing requirements. We recognize that the Dodd-Frank Act requires the Prudential Regulators and the CFTC to establish initial and variation margin requirements for uncleared swap transactions and appreciate the opportunity to comment on the Proposal. As a significant "buy-side" participant in the interest rate swaps markets that is subject to prudential regulation by FHFA, Freddie Mac believes it has a valuable perspective to provide to the Prudential Regulators regarding the effects of the Proposal, both on end users that will be required to post initial and variation margin to swap dealers that are "covered swap entities" (CSEs), and on entities that are required to collect initial and variation margin under the Proposal. We also recognize that the Proposal generally requires a CSE to comply with regulatory capital rules already made applicable to that CSE as part of its prudential regulatory regime, and we support this approach.

As an initial matter, we note that rules proposed by FHFA as part of the Proposal pursuant to authority under 12 U.S.C. 4513 and 12 U.S.C. 4526(a), would require all entities regulated by FHFA (Regulated Entities) to collect initial and variation margin when entering into swaps or security-based swaps with "swap entities" in a manner equivalent to the general margin requirements proposed for CSEs. If adopted as proposed, Freddie Mac would be required to both collect and post margin when entering into interest rate swaps with swap dealers. For this reason, (and because Freddie Mac's swap dealer counterparties will almost certainly transfer much of the economic cost of the mutual margin requirements to Freddie Mac), Freddie Mac will be especially affected by the Proposal and its business operations would be particularly harmed by rules that are unduly burdensome or that fail to provide for an orderly transition to clearing.

We believe that the transition to cleared swaps and the imposition of mandatory margin for uncleared swaps will be very costly, particularly in terms of the liquidity demands on market participants. As such, the magnitude of the increase in costs imposed by the new rules will likely have a very material effect on the incentives of hedging parties, such as Freddie Mac, to use swaps versus other instruments for hedging purposes. Indeed, mandatory margin requirements may, in fact, prevent commercial entities from hedging material business risks altogether. Therefore, we believe it is absolutely critical that implementation of margin requirements be carefully considered and measured to minimize the expected effects on liquidity and disruptions to the swaps market and the mortgage and housing markets.

In particular, Freddie Mac has the following recommendations, which are discussed in greater detail below:

- Freddie Mac strongly believes the best way to avoid significant market disruption is to implement the margin requirements on a schedule that (i) provides adequate time for the operational and business adjustments that will be required of both dealers and nondealers to adapt to daily, models-based margin requirements and (ii) is coordinated with the implementation of wide-scale clearing for interest rate swaps.

- With respect to methods for calculating initial margin, Freddie Mac believes that the "lookup" table contemplated in the Proposal uses categories that are too broad and imprecise to accurately reflect the risk associated with a specific swap transaction and thus the appropriate initial margin to be required. We recommend that the lookup table be greatly expanded to include a wide variety of categories to handle the various types of swap transactions that would likely be grouped under "interest rate swaps."

- With respect to variation margin and related documentation requirements, the Prudential Regulators should clarify that the parties to a swap are not required to agree to the mandatory use of a particularized valuation model for the swap in advance, but rather are required to agree to terms sufficient to establish the right of a CSE or Regulated Entity (together, Covered Entities) to collect variation margin as required by applicable law, subject to reasonable terms for the resolution of disputes.

- The Prudential Regulators should permit netting of variation margin among pre- and post-effective date swaps without requiring that pre-effective date swaps comply with the Proposal's requirements.

- The Prudential Regulators should clarify that mortgage-backed securities guaranteed by Fannie Mae or Freddie Mac (Agency MBS) are eligible collateral for initial margin.

- The Prudential Regulators should provide Covered Entities greater flexibility to establish thresholds and minimum transfer amounts based on approved policies and procedures for establishing such threshold and minimum transfer amounts, including the counterparty credit assessments made by the Covered Entities.

- Finally, the Prudential Regulators should adopt a standards-based approach to custodial risk that permits Covered Entities to use a custodian in a reasonable jurisdiction of their choosing. At a minimum, the Prudential Regulators should clarify that any custodian located in the United States satisfies the eligible jurisdictional requirements under the Proposal.

Discussion

I. Implementation Timing

Under the Proposal, initial and variation margin requirements would become effective within 180 days after the regulations are issued in final form. While the Proposal does not indicate when the margin rules are likely to be finalized, Freddie Mac has significant concerns about this proposed implementation schedule, which does not account for the amount of time that would be required to develop and implement appropriate margin models and does not appear to reflect any attempt to coordinate implementation with an orderly transition to clearing.

A. Application to Regulated Entities

In Freddie Mac's view, the time that would be required for Freddie Mac and other Regulated Entities to implement daily margining in accordance with internal margin models is likely to significantly exceed 180 days. This is due in large part to the complexity of developing such internal models. For example, the process of developing a model just for valuing relatively "plain vanilla" swaps is quite complex because such models involve dozens, if not hundreds, of assumptions and other factors. While certain inputs for interest rate swaps are fairly standardized, the development of proprietary interpolation techniques would be required to construct rate curves derived from observable data (we understand that each swap dealer uses its own technique). As swaps will be collateralized in various ways, proper valuation would also require modeling various risk and return factors associated with posting and/or holding different forms of collateral. And for purposes of establishing initial margin requirements, the task is substantially more complex because loss expectations must be assessed over the relevant modeling period using historical data and various simulation techniques.

Freddie Mac's practical experience demonstrates these challenges. As a significant participant in the interest rate swap market, we have engaged in substantial diligence of the offerings for clearing of interest rate swaps being developed by various derivatives clearing organizations. Two years after such diligence was begun, we are aware that at least one clearinghouse is still working on its margin models just for the limited suite of interest rate swaps that would initially be available for customer clearing.

Moreover, the demands of the undertaking are exponentially greater when multiple products are involved. Margin models for rate swaps used by Freddie Mac that contain embedded options or that are specially structured for bespoke transactions (such as our debt-linked swaps) will be immensely more complicated to produce than for simpler products. As there is frequently no way to interpolate from margin models for simpler products in building such models, model development would need to be conducted simultaneously along multiple tenors and structures.

Because Freddie Mac does not currently employ the margin models that would be required under the Proposal, the full cycle of development, validation, implementation and regulatory approval would need to be conducted prior to use of such models. Significant additional documentation and operational procedures also would need to be developed prior to implementation of margin requirements. Consequently, we believe that Freddie Mac would require at a minimum 12, and more likely 18, months to develop, test and be in a position to implement robust margin models for a significant portion of the products used for hedging purposes.

Further, even if we are able to develop successfully internal models for initial margin requirements, it is entirely unclear how (or whether) a buy-side institution such a Freddie Mac would be able to implement an internal models-based margin requirement, because swap dealers are unlikely to accept terms that would provide Freddie Mac with discretion in setting initial margin requirements. As a result, the most viable approach to promoting models-based margin as a realistic option may be the development and adoption of broadly accepted third-party models. To our knowledge, there are currently no third-party vendors offering models with the capacity to produce initial margin calculations similar to those proposed by the Prudential Regulators, much less for the variety of products we would trade.[2] Nor have we been informed

[2] While clearinghouses are fairly advanced in modeling margin for the limited range of products they would clear, such models are not capable of valuing more complicated rate products traded by Freddie Mac that are not currently clearable. As noted above, it is also not possible to interpolate margin for more complex products from these models.

of significant efforts to market models under development. We therefore believe that such models are unlikely to be available for many of the products traded by Freddie Mac within 180 days after the regulations are issued.

B. Application to Covered Swap Entities

While Freddie Mac cannot directly speak to the time it would take CSEs to implement models for interest rate or other swaps, CSEs would almost certainly need to develop models for a much wider variety of swaps than those traded by us. Given the difficulties involved, we are concerned that the proposed implementation schedule creates a material likelihood that the "lookup table" approach would be used by CSEs for many swaps for at least some period. Because the lookup table provides only a rough means of measuring swap risk, it is almost certain to set initial margin requirements at levels that are higher than necessary for sound risk management in many cases. Implementation of margin rules before CSEs (and Regulated Entities) have had adequate opportunity to finalize models would therefore cause an unnecessarily sharp increase in the funding and liquidity needs of market participants and have a negative impact on the financial markets.[3]

C. Relation to Clearing

Perhaps more critically, the proposed implementation date bears no implicit or explicit relationship to the likely timeline for building out capacity for the safe clearing of swaps on a broad basis. The margin model and margin lookup table provisions proposed by the Prudential Regulators clearly contemplate that margin requirements for uncleared swaps will be substantially higher than for cleared swaps under either the lookup table or internal model methodology. As such, implementation of margin requirements for uncleared swaps prior to the development of capacity to clear swaps on a broad basis will create very substantial liquidity effects and economic dislocations for large users of swaps such as Freddie Mac, and will have material adverse effects on the economy. Of particular concern to Freddie Mac, early implementation will also indirectly increase costs for mortgage providers and homeowners. Recent estimates indicate that aggregate initial margin requirements for one year under the Proposal could total in excess of $2.5 trillion.[4]

Therefore, Freddie Mac strongly recommends that the implementation of mandatory margin requirements be coordinated with the transition to clearing. In this regard, we note that interest rate swaps are by far the largest segment of the swaps market and that industry efforts are well advanced to establish a robust capacity for customer clearing of such swaps. As such, it is generally expected that interest rate swaps will be the first category of swaps subject to mandatory clearing. Given that work on clearing of interest rate swaps is well advanced and the

[3] By way of illustration, initial internal assessments indicate that Freddie Mac would be required to post approximately $8 billion in additional initial margin based on the lookup table methodology in order to margin that portion of its existing swap book that consists of products for which clearing is not currently available. To the extent we are unable to post securities as initial margin and do not have sufficient cash on hand to post as collateral, we would likely have to make increased use of our debt program to satisfy the initial margin requirement.

[4] See Matt Cameron, *US Margin Proposals Could Lock Down $2 Trillion in Assets*, RISK MAGAZINE, June 2, 2011 (citing an Office of the Comptroller of the Currency estimate based on the annual average growth in notional swap amounts).

strong legislative and regulatory preference for clearing as expressed in the Dodd-Frank Act, Freddie Mac believes that it would be desirable at least to coordinate the effectiveness of mandatory margin for uncleared swaps with the development of a robust clearing capacity for interest rate swaps in order to better balance the goal of systemic risk reduction with the imperative of avoiding unnecessary shocks to the financial markets.

II. Initial Margin

Under the Proposal, the amount of initial margin that must be collected by a Covered Entity is determined by reference either to a "lookup table" appearing in the regulations, or by reference to a privately developed model approved by the appropriate Prudential Regulator. As a general matter, Freddie Mac believes that the proposed lookup table will be a relatively unattractive alternative for most Covered Entities. As the Prudential Regulators recognize in the Proposal:

> In many cases, ... the use of a standardized [lookup] table may not accurately reflect the risk of a portfolio of swaps or security-based swaps, because the swaps or security-based swaps themselves vary in ways not reflected by the standardized table or because no reduction in required initial margin to reflect offsetting exposures, diversification, and other hedging benefits is permitted....

Freddie Mac concurs that the proposed lookup table does not accurately reflect the risk of the wide range of swaps that could be covered. We believe the form of the lookup table set forth in the Proposal generalizes risk across too many product types and categories, which can result in inaccurate calculations of appropriate margin requirements. Moreover, the proposed lookup table mandates the use of a swap's notional amount as the basis for initial margin calculation, which does not necessarily reflect the true risk of a given swap, particularly with respect to swaps with longer maturities. The lookup table also does not take into account the wide variety of other terms that could differentiate swaps, such as optionality. Nor does the lookup table enable a Covered Entity to offset risks, and thus tends to overstate the overall risk of a given portfolio.

The fundamental flaw with the proposed lookup table is that it categorizes risk too broadly across dissimilar products. The categories provided in the proposed lookup table would have to be greatly expanded to handle the various swap transactions that would likely be grouped under "interest rate derivatives." Even if this occurred, it is still unlikely that the true risk of these varying swap transactions would be accurately reflected in table-based calculations tied to notional amounts.

At a very basic level, the proposed lookup table's asset classes are too broad, particularly the tenors of the swap transactions categories. The table currently lists only three different duration levels for interest rate products: 0-2 years, 2-5 years and 5+ years. The shortcoming with this formulation is that it results in the same amount of margining for products with vastly different risk characteristics. As an example, the DV01 of a $1 million 7-year swap would be approximately 600, while a $1 million 30-year swap would have a DV01 of around 1,600.[5] The risk of these transactions is obviously very different, yet both transactions would have the exact

[5] "DV01" is the dollar value change in the value of a swap resulting from a one basis point decrease in rates. In this example, the price of a 30-year swap would move nearly 2-1/2 times as much as the price of a 7-year swap if rates moved by one basis point.

same margin requirements under the current table. At a bare minimum, the table would need to have more tenor divisions and the maturity buckets would need to be expanded.[6]

Moreover, we believe it is inappropriate to group all products related to interest rates into one category. This would likely include caps, floors, swaptions, swaps with optionality and similar swap transactions that have very different risk profiles. These transactions entail various option types, lockouts and related features that result in very different risk profiles. Using only the tenor of the transaction to determine the margin requirements means the risk of most of these transactions is not accurately reflected in the proposed lookup table.[7]

III. Variation Margin

A. Documentation Requirements

Freddie Mac generally supports the Proposal's provisions regarding daily posting of variation margin. However, the proposed requirement that parties execute trading documentation specifying "the methods, procedures, rules, and inputs for determining the value of each swap or security-based swap" potentially raises very significant concerns.

As an initial matter, we note that the CFTC has proposed in a parallel rulemaking to require swap dealers to execute documentation with customers at the initiation of each swap that would specify the valuation methodology and inputs with sufficient specificity to allow a third party to independently value the swap using the specified methodology.[8] In other words, parties would be required to contractually commit to using an agreed valuation model and "objective" inputs before entering into each trade.

Because the documentation requirements provided in the Proposal are phrased in somewhat broader terms, it is unclear to us whether they are intended to impose requirements similar to those proposed by the CFTC. To the extent the proposed documentation requirements are simply intended to require that parties set forth the general principles and methodology for determining valuations consistent with current practices, Freddie Mac would support such a requirement. However, if this Proposal may be intended to impose a requirement that parties to a swap agree to the use of a specific valuation model prior to trading, we believe the Proposal would be extremely difficult to implement and could have several adverse and unintended consequences.

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[6] For example, the CME uses 9 maturity buckets in its models, while the proposed look-up table has 3 maturity buckets. We note that even if the number of maturity buckets were expanded, we still believe that any table based methodology that relies on notional amounts to set margin requirements greatly over-simplifies the risk differential across the broad spectrum of instruments that would be included. Any viable risk methodology would require a set of tables with different product types being subject to different margin requirements.

[7] We also do not believe that factoring into the lookup table offsetting positions or offsetting margin requirements is practical. A significant shortcoming to such an approach is that the wide variety of interest rate swap terms that we have mentioned above would exacerbate the inaccuracy when used in an offsetting manner. For example, positions that do not match in risk terms could be seen as offsets simply because their tenors otherwise match.

[8] See 76 Fed. Reg. 23732. See also, 76 Fed. Reg. 6715 (proposed swap trading relationship documentation requirements).

In Freddie Mac's experience, while the parties to interest rate swaps endeavor to eliminate subjective elements from valuation computations, eliminating *all* discretion of the parties to compute valuations both assumes a level of precision which may not be possible and, effectively, may produce a commercially unreasonable result based upon application of a predetermined and unvarying formula. Moreover, Freddie Mac believes such contractual precision, and the elimination of all discretion in valuations, is simply unnecessary.

Currently, when parties enter into a swap transaction under standard ISDA documentation, the transaction documentation generally establishes which party or parties to the trade will determine the value of the swap for purposes of collecting margin, imposes on that party a duty to act in good faith and in a commercially reasonable manner, and provides non-judicial dispute resolution mechanisms.[9] Further, ISDA documentation permits parties to a swap to value the transaction "dynamically," meaning that they may adjust their valuation models during the term of the transaction. Although the ability to change a valuation model does give rise to the possibility of valuation disputes, this dynamic approach more significantly allows the parties to adjust their valuations in light of changes to market conditions and their understanding of the markets.

Freddie Mac typically uses the 1992 version of the ISDA agreement, which provides for valuations based on the specified valuation agent's estimate of the mid-market quote for replacement transactions.[10] When Freddie Mac's counterparty is the valuation agent, the counterparty provides daily valuations, which we understand are generally derived from the counterparty's internal models. Freddie Mac's practice is to validate these valuations by obtaining and averaging multiple market quotes from leading third-party dealers.[11] In the case of a material disagreement, Freddie Mac retains the contractual right to dispute the relevant valuation through an agreed procedure using additional quotes from third-parties. The foregoing methodologies have served Freddie Mac well over the years, both for administering the movements of margin for performing counterparties and for calculating the close-out amount for defaulting counterparties.[12] To the extent the Proposal effectively requires the parties to agree on a fixed valuation model established at the initiation of a swap and to maintain that model through the term of the swap, the Proposal is dramatically inconsistent with Freddie Mac's and the industry's current practices.

While the establishment of a fixed and inflexible valuation methodology arguably would eliminate the possibility of subsequent disputes over valuation (and hence disputes over the amount of variation margin required), such a standard would likely result in substantial obstacles to the negotiation and execution of final swap documentation by the counterparties. To begin with, parties would almost certainly use different valuation methodologies in the ordinary course and would likely favor their own methodologies over the methodologies proposed by

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[9] However, swap counterparties do not ordinarily lose the right to litigate unless they have agreed to binding arbitration, which is unusual.

[10] The 2002 ISDA version of the agreement affords the parties additional discretion in the calculation of swap valuations.

[11] In some cases it is necessary to interpolate between observed quotes to accurately value a position or to use an internal estimate of expected losses.

[12] Freddie Mac's current swap valuation methodology provides a level of verification and validation assurance that is fully sufficient for both financial and regulatory reporting purposes.

counterparties. Given the enormous complexity of valuation models, negotiating "agreed" models (really compromise models) for each swap would be extremely difficult and time consuming. The difficulty of negotiating valuation models would likely result in a take-it-or-leave-it approach, with swap dealers simply requiring counterparties to adopt the dealers' methodologies. End users such as Freddie Mac would therefore face the prospect of being required to "agree" to numerous different valuation models from their swap dealer counterparties, each one of which would likely differ from the end users' actual valuation assessments, and to forgo the ability to dispute a CSE's valuations.

Moreover, valuation models by their nature should not be fixed and unvarying, but rather should be flexible and dynamic. Swap valuations necessarily involve making ongoing judgments about external factors and using inputs and economic assumptions that reflect the best knowledge and technology available at the time of each valuation. As external factors and assumptions change, valuation models must be adjusted. To require parties, at the initiation of a trade, to specify a model to properly value the trade throughout its term is thus to expect the parties to anticipate all potential future market conditions during the term of the trade, and to adhere to existing economic assumptions that may later prove unrealistic. In fact, agreeing to a fixed and unvarying valuation model will likely result in the use of valuation models that do *not* properly reflect the market's value of the swap over time.

Freddie Mac believes that, for purposes of calculating variation margin, a more adaptive approach is required. Consistent with ISDA practices, trading documentation should specify the general principles for calculating swap valuations and the resulting variation margin, and should designate the party (or agent) responsible for the calculation. The documentation should further provide the counterparty with reasonable dispute rights and procedures to resolve disputes promptly. Requiring the regulatory reporting of aged disputes above a reasonable materiality threshold can mitigate regulatory concern with unresolved disputes.

B. Combining Pre- and Post-Effective Date Swaps Under a Qualifying Master Netting Agreement

We disagree with the Prudential Regulator's proposed conditions for netting variation margin for pre- and post-effective date swaps. The Proposal would permit a Covered Entity to calculate and net the amount of variation margin required to be delivered by the counterparty under a single qualifying master netting agreement only if the Covered Entity complied with the proposed variation margin requirements with respect to all swaps under the agreement, including pre-effective date swaps. While combining pre- and post-effective date swaps under a single ISDA master agreement poses certain practical challenges from an operational and documentation standpoint, we are aware of no compelling policy reason to require retroactive application of the proposed variation margin requirements to pre-effective date swaps as a condition for netting, and the Proposal does not articulate any such rationale.

Assuming it were enforceable, imposing such a condition on the availability of netting would effectively require parties to upset the benefit of freely struck bargains with respect to their pre-effective date swaps. To the extent that the Proposal is intended to impose a requirement to document agreed valuation models (as discussed above), Freddie Mac believes that few pre-effective date swaps would satisfy the requirement, and parties would be compelled to engage in a costly and time-consuming redocumentation process. In addition to this potential documentation issue, the proposed condition would potentially impair Covered Entities' ability to apply previously agreed thresholds and minimum transfer amounts to pre-effective date swaps.

At the same time, the proposed requirements with respect to pre-effective date swaps appears to be largely unenforceable. Given that variation margin is not subject to a mandatory segregation requirement, a Covered Entity receiving collateral as variation margin with respect to one set of swaps (*e.g.*, pre-effective date swaps) could always simply re-post that same collateral as variation margin to its counterparty for other swaps between the parties (*e.g.*, post-effective date swaps). Netting simply achieves the same economic result in a more efficient manner. Consequently, the Proposal appears to have little more effect than to raise costs for netting and encourage the use of different master agreements for pre- and post-effective date swaps. Under the circumstances, Freddie Mac believes that the eminently more reasonable approach is simply to permit netting of variation margin between pre-effective date and post-effective date swaps.

IV. Eligible Collateral

The Proposal would limit eligible initial margin to (1) cash; (2) direct obligations of, or obligations guaranteed as to principal and interest by, the U.S. Government; (3) senior debt obligations of Fannie Mae, Freddie Mac, Farmer Mac, or any Federal Home Loan Bank; and (4) an insured obligation of a Farm Credit System bank. Because the scope of what constitutes "senior debt obligations of" Fannie Mae and Freddie Mac (the Agencies) is somewhat unclear, it appears Agency MBS may be excluded.

Freddie Mac believes that Agency MBS should be included within the category of eligible collateral. Agency MBS is widely accepted as eligible collateral in the current OTC market, is guaranteed by Fannie Mae and Freddie Mac and is therefore effectively *pari passu* with their senior debt obligations.

We also note the significant commitment from the Department of the Treasury (Treasury) to support the Agencies through the Senior Preferred Stock Purchase Agreements entered into between Treasury, Freddie Mac and Fannie Mae (the Purchase Agreements).[13] The support provided by Treasury enables Freddie Mac to maintain access to capital markets and ensures liquidity to facilitate normal business activities. As noted in a letter opinion of the Principal Deputy Assistant Attorney General, the Purchase Agreements create enforceable rights against Treasury for the holders of debt securities referred to therein and beneficiaries of Mortgage Guaranty Obligations issued by the Agencies.[14]

V. Thresholds

For purposes of the margin requirements applicable to CSEs and Regulated Entities, the Proposal would establish permissible thresholds based on whether the counterparty is itself a CSE, "high-risk financial end user," "low-risk financial end user," or "non-financial end user." Zero thresholds would be required for counterparties that are CSEs and "high-risk financial end users," while limited thresholds would be permitted for "low-risk financial end users" and fully discretionary thresholds would be allowed for "non-financial end users." The Prudential

[13] *See* U.S. Department of the Treasury press release dated December 24, 2009 at http://www.treas.gov/press/releases/2009122415345924543.htm.

[14] *See* "Enforceability of Certain Agreements Between the Department of the Treasury and Government Sponsored Enterprises," Letter Opinion for the Secretary of the Treasury (September 26, 2008) at http://www.justice.gov/olc/memoranda-opinions.html.

Regulators explain these different treatments by asserting that financial counterparties are more risky than non-financial counterparties because their profitability is "more tightly linked to the health of the financial system." As a consequence, financial counterparties are deemed more likely to default in a period of financial stress. Similarly, "high-risk financial end users" are considered more risky than "low-risk financial end users" because their uncleared swaps books are larger and are used primarily for investment rather than hedging, and because they are not capital regulated by a Prudential Regulator or a state insurance regulator.

While Freddie Mac agrees that, all else being equal, stress (to the extent confined solely) to the financial markets is likely to be more significant to the profitability of financial institutions than to the profitability of non-financial institutions, we strongly disagree that differentiation by a single variable (*i.e.*, whether the counterparty's business is financial vs. non-financial) is an appropriate proxy for counterparty credit risk or contribution to systemic risk. Similarly, we disagree that credit risk can be assessed by looking at a portion of a counterparty's balance sheet (*e.g.*, its derivatives book) in isolation. A comprehensive approach to assessing the credit risk posed by a given counterparty depends on the totality of the counterparty's balance sheet and activities because any credit assessment is necessarily a detailed and holistic exercise.

Moreover, Freddie Mac does not believe that its current practice of allowing moderately sized thresholds to financial counterparties poses meaningful systemic risk. By definition, the potential counterparty exposure presented by the application of a threshold is limited to the threshold amount. As such, a threshold amount is little different than a credit facility, and it is unclear why such facilities should be prohibited in this context when they are otherwise permissible in other arrangements with the counterparty, subject of course to appropriate underwriting and monitoring standards and proper capital treatment. Appropriate policies for the sizing of threshold exposures in light of available capital and for avoiding highly correlated exposures across counterparties should adequately address risk in this context.

In light of the foregoing, Freddie Mac believes that mandatory zero thresholds for counterparties that are CSEs and financial end users with swap books that exceed arbitrary limits are unwarranted. Determination of an appropriate threshold should reflect the considered judgment of a Covered Entity regarding the acceptable level of counterparty-specific credit exposure in light of the same considerations and analysis that govern credit policies generally.

Moreover, we note that the proposed approach to thresholds is not consistent with the rest of the Proposal. In general, the Proposal contemplates an approach to managing credit risk that recognizes that Covered Entities generally have risk information that is superior to that of the prudential regulators, and allows Covered Entities to utilize that superior information through the implementation of flexible, models-based regulation. The Proposal therefore encourages Covered Entities to establish initial and variation margin requirements subject to regulatory supervision and oversight. Such an approach is also appropriate for establishing thresholds, and imposition of rigid and inflexible limits is likely to encourage regulatory arbitrage. If a Covered Entity's credit procedures for establishing, maintaining and adjusting thresholds have been reviewed and approved by regulators, the Covered Entity should be permitted to provide thresholds in accordance with its considered views and credit risk tolerances.

VI. <u>Minimum Transfer Amounts</u>

The Proposal provides that no initial margin (or variation margin) is required to be transferred if the amount of initial margin (or variation margin) otherwise required to be transferred is less than $100,000. No flexibility is afforded to Covered Entities to establish higher minimum transfer amounts.

Freddie Mac believes that Covered Entities should be given some ability to establish higher minimum transfer amounts when circumstances warrant. The appropriateness of a given minimum transfer amount is highly dependent on the Covered Entity, the creditworthiness of the counterparty, and the size and volatility of the swap. As with thresholds, the balancing of the credit risk associated with minimum transfer amounts against other considerations (in this case the operational benefits of avoiding frequent small transfers) is best left to the discretion of the parties, subject to regulatory review and oversight.

VII. Custodial Arrangements

The Proposal requires that, if a Covered Entity is required to post margin to a counterparty, the funds must be held by an "independent custodian [that] is located in a jurisdiction that applies the same insolvency regime to the independent custodian as would apply to the covered swap entity." While Freddie Mac appreciates that the apparent objective of this requirement is to provide certainty regarding the Covered Entities' rights to the collateral in the event of the insolvency of the custodian, the requirement itself is somewhat vague. Moreover, in certain circumstances, the requirement becomes unworkable, as explained below.

As an initial matter, the phrase, "in a jurisdiction that applies the same insolvency regime to the independent custodian as would apply to the covered swap entity" is ambiguous. If the phrase is construed literally to require that the exact same insolvency laws must apply to the custodian as to the Covered Entity providing collateral, the requirement would be impractical. While an eligible custodian for an FDIC-insured bank could be another FDIC-insured bank, for entities such as Fannie Mae and Freddie Mac (which are governed by special insolvency laws), the only eligible custodians would be each other (assuming they could provide custody services).

Assuming the phrase was intended to refer simply to custodians located in the same geopolitical jurisdiction as the collateral provider, the standard would still raise significant difficulties in connection with cross-border swap transactions. For example, if a U.S. bank and a German bank were to enter into a swap transaction, arguably, *two* custodians would be required – one governed by U.S. law holding the U.S. bank's margin, and the other governed by German law holding the German bank's margin.

The inherent flaw with the Proposal's approach is that it incorrectly assumes that only the posting party has exposure to the custodian's insolvency. *Both* parties to a swap transaction have exposure to the insolvency of the custodian. For example, as a receiver of collateral from an overseas CSE, Freddie Mac would have a compelling interest in understanding the custody risk when dealing with an overseas custodian, particularly as the risk of bankruptcy of such a custodian might be significantly correlated with the bankruptcy risk of the CSE counterparty. Indeed, if adopted in its current form, the Proposal could create significant disincentives for Freddie Mac to transact with certain non-U.S. swap dealers because Freddie Mac would be legally *obligated* to hold its collateral abroad.

Freddie Mac believes that the parties to a swap transaction should have discretion to choose custodians in non-U.S. jurisdictions subject to reasonable diligence as to custody risk including, as necessary, obtaining appropriate legal opinions. Moreover, for swaps subject to U.S. regulation, any custodian located in the U.S. should always satisfy the acceptable bankruptcy jurisdiction requirement under the margin rules without regard to the location of the collateral provider.

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Freddie Mac appreciates the opportunity to provide its views in response to the Proposal. Please contact me if you have any questions or would like further information.

Sincerely,

LM Ledbetter

Lisa M. Ledbetter